

RICHARD RUSSELL'S DOW THEORY LETTERS, INC.

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LETTER 717

Dec. 9, DJIA 815.25; PTI 802; A-D ratio -20.12

Dec. 16, DJIA 815.32; PTI 796; A-D ratio -20.20

THE PICTURE: I can't remember 'em all, but I'd say that in almost every year since I've been in this business there's been a catchy "saying" to explain why the market couldn't do this or that. Of course, invariably the market did do this or that, but those little things don't bother Wall Street. The next year the Street will come up with a new catchy phrase. For instance, in the mid-1950's the phrase was that "Wall Street was running out of good stocks." The 1957 collapse showed us that there were all the good stocks we wanted—at discounts. In the late-1960's we heard that the "growth stocks would just keep going up and up, because they had mastered the secret of perpetual growth." Maybe so, but you can buy most of those growth stocks today for about a 66% discount on their P/E ratios.

This year's catchy phrase was (and still apparently is) that "stocks can't go down because they are so damn cheap." Unfortunately, a lot of stocks didn't understand, because they are considerably lower now than they were in January, 1977 or June, 1977. And the Dow has put on an spectacularly poor performance, giving us a single 5% rally within a 16-month decline.

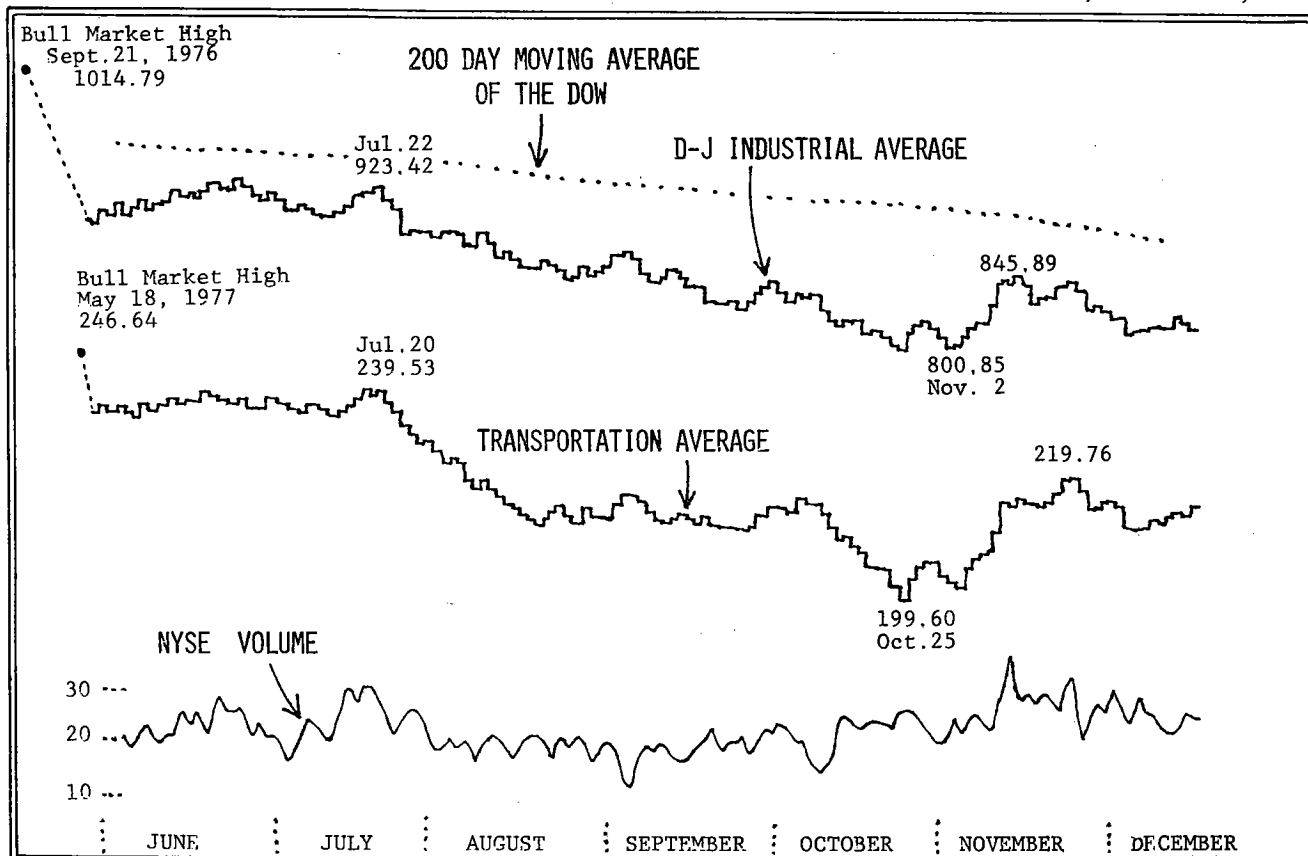
Because a number of stocks have tended to resist the decline, complacency seems to have enveloped Wall Street and Main Street. The attitude seems to be, "Who needs the Dow?" My only commentary is that I think the Dow (in its 16-month,

dismal decline) is telling us that there are going to be many revisions in the current rosy year-end forecasts for 1978. I don't think the Dow has put on this crushing bear market performance in a vacuum. Next year, it's my guess that we'll find out what the decline was all about.

What I am leading up to with all this is that in all the years that I've been writing this report, I have never seen a domestic and world situation like the current one. Here we have sliding stock markets in virtually every nation in the Free World. We have stagnant economies in almost every nation. The major reserve currency, the dollar, is sick. Furthermore, we are witnessing a situation in which the US is being singularly unsuccessful in "pressuring" its trading partners to come to the aid of the dollar.

Why won't Germany and Japan "inflate a little" or lower tariffs importantly to help the swooning US dollar? Simple, they won't do much because these exporting nations are both on the edge of trouble in their own economies. Benevolent "bail-outs" are for prosperous times when all the partners are bright-eyed and bushy-tailed. When the going gets rough, it's every man for himself—and that's about where the world is now.

As I see it, the US is in trouble on both the liquidity and the monetary fronts. The nation is loaned up from one end to the other, and that old fever barometer, interest rates, is about to



start talking. In recent reports I have shown how the bond market has been creeping lower (with long-term interest rates moving higher). In this report I include another piece about the sorry state of US finances. All this the stock market is "mulling over" and discounting. And the technical position of the stock market, according to my studies, is reflecting trouble ahead.

THE MARKET: As far as Dow's Theory is concerned, the picture is relatively clear. A primary bear market is in force. October-November lows were recorded (see page 1 chart) at **800.85** for Industrials, **199.60** for Transports. A rally into mid-November took Industrials to **845.89**, Transports to **219.76**. The next major swing of the market will be signalled by a *joint penetration* of 845.89 and 219.76 on the upside—or 800.45 and 199.60 on the downside.

During a bear market the passage of time always favors the downside (values during a bear market deteriorate through time). Furthermore, at the mid-November peaks we witnessed a high-volume non-confirmation. Thus, a good deal of distribution probably took place at the November highs. Without wanting to play the part of soothsayer, I nevertheless infer that the next important movement in this market will be down. And the longer the time elapses without a bettering of the mid-November peaks, the more the odds favor the downside path.

If the Averages do head for lower levels, a first critical test will be the 796.19 or halfway level for the Dow. Under the **50% Principle** (of which I have written so much), the 796.19 Dow level represents a most important theoretical point. For 796.19 is the halfway level of the entire preceding bull market, a bull market that carried the Dow from 577.60 to 1014.79. If that

halfway level (796.19) is *decisively* broken, then the market scales will tip heavily towards the downside. In that case I would expect the ultimate Dow low for this bear market to be in the 600's, and I would not write off an ultimate testing of the 1974 low of 577.60.

SHORT-TERM: It should be remembered that there is a seasonal influence in the month of December that favors *some kind of rally*. Therefore, it would not be surprising to see the market bounce up between now and year-end. If so, I would not take such a move as anything more than an "automatic knee jerk at Santa Claus time." January should tell us a lot more of a true story than any action in December.

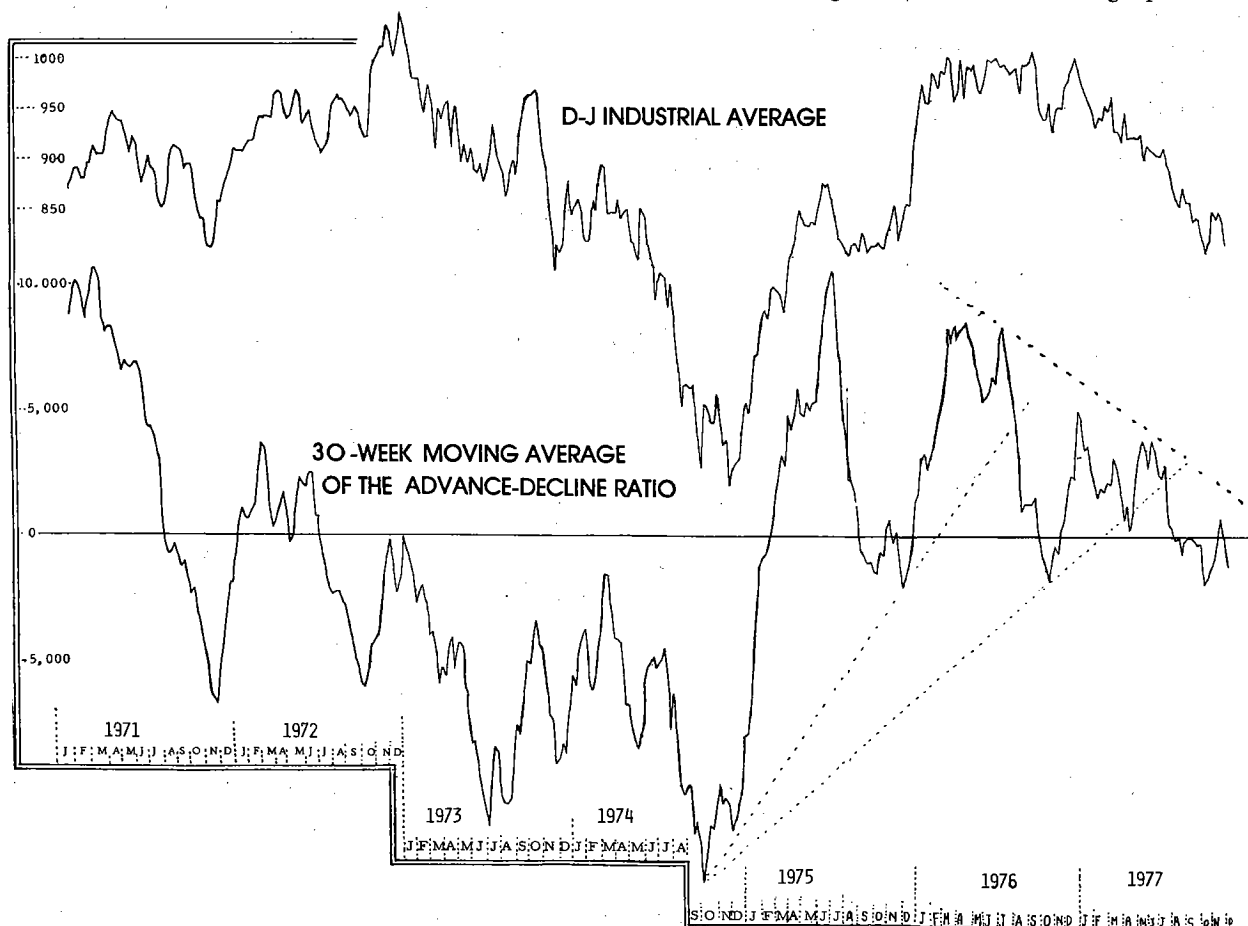
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The moving averages of the Dow (MA's) are in interesting positions now. This week the 4-week (short-term) MA is 823, just 3 points below the 13-week MA, which is 826. The 13-week in turn is 70 points below the long-term or 50-week MA. The 4-week will often rise and touch the 13-week during a correction within a major decline. That may be what we have seen here, but the operative factor is that the 13-week MA is still far below the 50-week, and a major bull signal on this study requires a crossing by the 13-week MA above the 50-week MA.

LONG-TERM BREADTH: I am including my chart of the weekly NYSE advance-decline *differentials* plotted on a 30-week moving average. This study is telling a story that fits into my thesis of a forthcoming major decline in the majority of stocks on the NYSE (as measured by the A-D ratio).

Note the huge up-thrust of the breadth index during early 1975. After a corrective decline to below the zero line, the index thrust up again during early 1976. Again (during mid-1976) the index slid to below the zero line. Two further rallies appeared in the index, one during late-1976 and one during April-June of 1977.



Then for a third time the index sank below zero. In late-November we saw a very minor push above zero, but this latest push faded almost immediately. Last week the index dropped again, this time below the three preceding "below-zero bottoms."

With last week's action, I feel the chart is telling us that the "upside potential" for the A-D ratio is about exhausted. Each advance in the index since early-1975 has been weaker than the last. At this point the index may be ready to spend an *extended period of time below the zero level*. If so, we could see a breadth slide which could easily be the severest since 1974.

THINGS TO COME: At any given time the stock market has built into it what I term a "major upside potential" or a "major downside potential." That means that within the structure and fiber of the market, there is a target, a target which the market "wants to get to." That may sound rather mysterious but when you have been in this business a while, you realize that it is true.

How the market gets to the target is something else again. For instance, if the Dow is at 500 and it has an upside potential (target) of 1000, the Dow may get there in three bull swings, it may get there in one tremendous bull swing, or it may get there in a series of rises and declines taking 1, 3 or 5 years or more. It **doesn't matter** how it gets there, but the important thing to understand is that it is going to reach that potential.

At this time I believe the market has an important downside potential. I base that statement on a number of factors. One factor is that the Dow "failed" dramatically on the upside under my Elliott studies, as explained in Letter 714, page 3. This failure, I believe, was a very bearish event, and it required a very bearish scenario to produce that kind of failure.

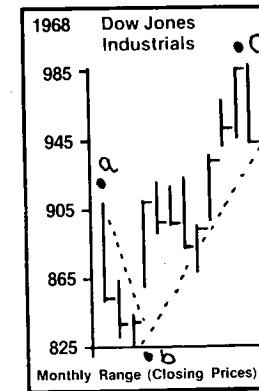
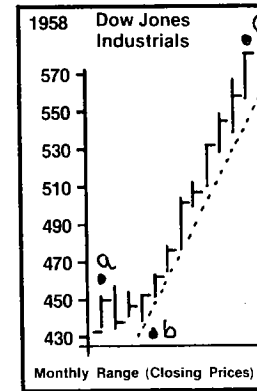
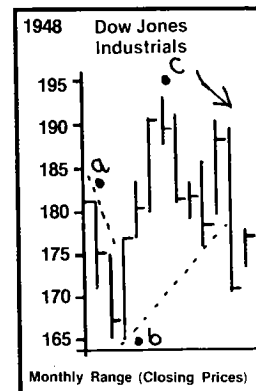
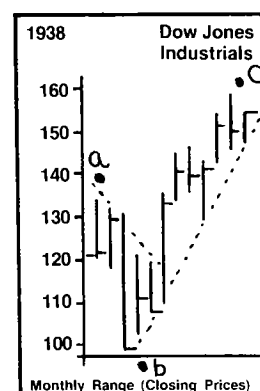
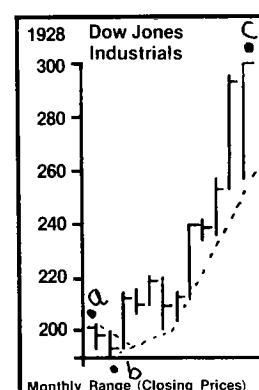
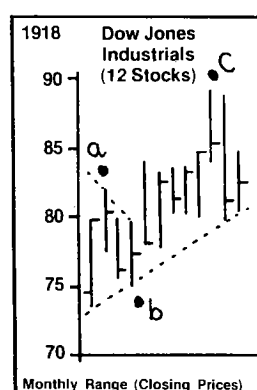
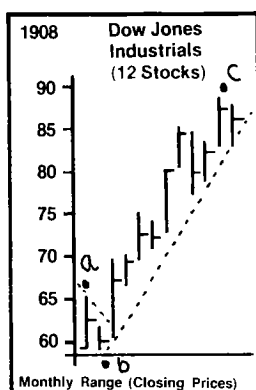
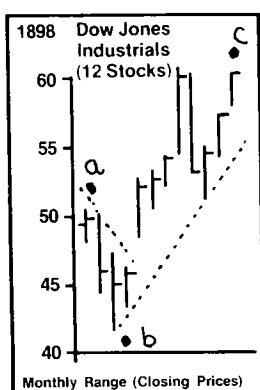
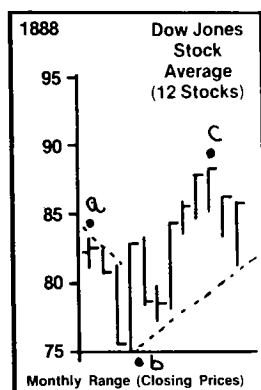
"All right," you retort, "but the Dow has now lost almost half of its 1974-76 gains. What makes you think that the bearish potential has not been fully expressed yet?" And that is what I want to go into next.

In the last Letter I discussed "a private indicator" which I keep that is based on a broad section of the market (breadth). This indicator has recorded a major and important low every, 2, 3 or 4 years for the past quarter century—but it has **never gone more than 4 years** without recording a major low. And when I say "major low," I am talking about lows such as 1957, 1962, 1966, 1970 and 1974.

The crucial current fact about this indicator is that it has not been to a major low since September-October, 1974. Next year, 1978, will be the fourth year that this indicator has resisted a major low. That means that the **odds are high that this indicator will move down to its cyclical low next year.**

You may ask, "Well, what could happen to take your indicator down to a low next year?" And my answer is that I don't know. I could guess, and so could you or anyone else, but I don't really know. I do know that in the last three decades we have seen booms, recessions, wars, credit crises, inventory build-ups, good times, monetary shocks, what have you. Despite any and all variations and changes, this indicator has always recorded its major low every 2, 3 or 4 years—**BUT NEVER LONGER!**

Next, I'm going to attempt to fit my indicator into the "decennial pattern" and show you what I think could be coming up. The decennial pattern is the concept put forth by Edgar Smith and Anthony Gaubis many years ago. This concept notes that there is a strong similarity in each of the same years in each successive decade. Thus the "7 years," such as 1907, 1917, 1927, 1937, etc., tend to be poor years. And we have seen that tendency this year, in 1977.



Charts
courtesy of
Yale Hirsch's
1978 STOCK
TRADER'S
ALMANAC

The "8" years, however, have tended to start out with minor to major declines, but the 8-years also tend to end up as good years. I have included these decennial charts through courtesy of Yale Hirsch's *1978 Stock Trader's Almanac* (6 Deer Trail, Old Tappan, NJ 07675). Here we see nine "8-years" tracings, representing nine previous decennial cycles. I have drawn two dotted trendlines on each chart, the first trendline in each case points down, and this represents the initial decline in each 8-year. The second trendline slants up, and it represents the later major advance for each 8-year. I have also labeled this decline-and-advance pattern with an a-b-c so that each 8-year pattern can be seen more clearly.

The decline-advance tendency of the 8-years has actually been **remarkably persistent and uniform**. Note on the charts that the years 1888, 1898, 1938, 1948 and 1968 witnessed the severest early-year declines, prior to the later major advances. The only 8-year that showed any real deviation from the decennial pattern was 1948. In that year we see the normal a-b early decline, the normal b-c later advance. But at mid-year the Dow turned down—rather than continue its usual advance to year-end. Even so, December, 1948 ended substantially above point b for the Dow.

All right, what is my conclusion based on my breadth indicator and based on the decennial pattern? My conclusion is this: I think there is a good chance that we will see a major, very important decline to start early in the year 1978. This decline, which could last anywhere from three to six months, should take my indicator to its *first cyclical over-sold area since 1974*. After that, the market should turn up and follow the normal 8-year advancing pattern.

Now assuming I am correct, I want to state that one factor particularly puzzles me. It is that in every 8-year, the initial declining phase has ended fairly quickly, actually *within four months* (or by April). But my private breadth indicator is currently at a *very high level*, which means that it has a long way to drop if it is to go over-sold in early 1978, or within the first four months of 1978. Therefore, my conclusion is that the decline I foresee that is scheduled for 1978 should be a drastic affair, and it should be an across-the-board slide. In other words, whereas 1977 saw the Dow stocks go down, the 1978 decline should take the rest of the stocks down.

Question: If 1978 shapes up according to your visions, how far do you see the Dow going on the downside?

Answer: I have no preconceived notions, but I would say far enough so that even the stubbornest bulls of today (and there are still a lot of them) will concede that they have been fighting a bear market. I might as well say again that it is always easier (and safer) to try to identify a bottom—rather than to predict one.

Question: All right, and how do you suggest that we operate in the period ahead?

Answer: My position is that there are two strategic investment problems: (1) Any one with capital must now protect himself against the possibility of a sudden collapse in the banking system. Gold will afford a good measure of protection, and Treasury bills will also afford protection. (2) But there is also the problem of **timing**. Since the timing is extremely difficult and open to all kinds of error, my position is that we should put 10% to 20% of our assets in gold (bullion or coins) and forget about it.

Question: What about buying stocks during 1978?

Answer: At this point, I believe we are in a primary bear market. However, I realize that this is a very confusing situation in the history of the stock market, and I have decided that I will almost surely recommend purchases of stocks at the next fully *over-sold bottom*. We have not seen such a bottom since November, 1976, but I believe we will see a fully over-sold situation before the first half of 1978 is over.

Question: If you think we're in a primary bear market, how can you also think about buying stocks?

Answer: Following the late-1974 bear market bottom, we saw a bull market that lasted about two years. This might be termed a short bull market. It is possible that we are now in a rather short bear market. Regardless of what you and I think of the fundamentals, this bear market could conceivably last about as long as the preceding bull market (actually, most bear markets are *shorter* than the preceding bull market). Since this bear market is now almost 15 months old, it is possible that the next over-sold bottom will represent **THE** bear market bottom as well.

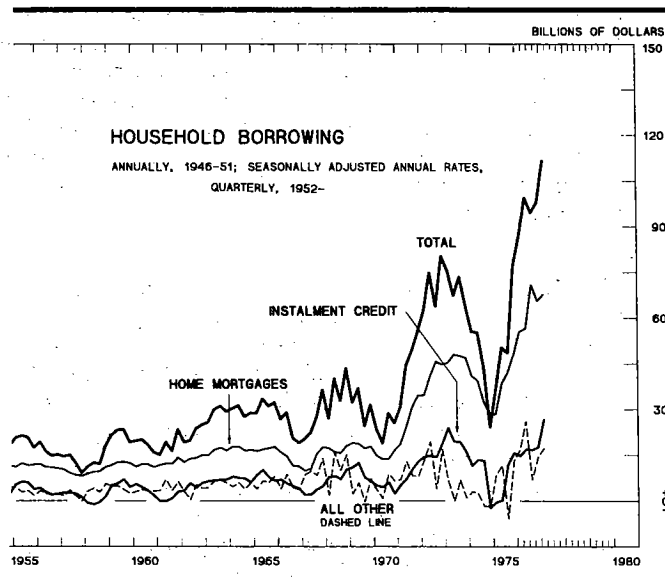
Referring to page 3 of Letter 714, I showed that under Elliott we have now witnessed two major down-waves. The inference is that a third down-wave is in the offing. Therefore, any decline which takes the Dow below 800.85 will represent the third down-wave of this bear market—and possibly the final wave. If such a wave results in an over-sold bottom, we will buy stocks.

FINANCING "PROSPERITY": The more I read about the debt and credit structure of this nation, the more worried I become. In the November 28 issue of the *Wall Street Journal* there was an article about the financial plight of NYC. Experts estimate that it will require \$1.6 billion in new (long-term) financing to put NYC back in fiscal shape. But NYC just dropped a \$200 million short-term financing plan because the market **wouldn't accept its new debt**. So the odds on NYC's long-term financing of \$1.6 billion are zero or minus-zero. The fact is that NYC is still broke, stone cold broke. The only thing that has changed is that NYC's debts have been *re-shuffled*!

On the Federal level, about which I've been writing a good deal, we have the momentous problem of the budget and the trade deficits. Under the heading of "one picture can say more than 1000 words," I include this chart from the latest Federal Reserve Historical Chart book. What it shows is the frightening build-up of foreign claims on US dollars in foreign hands. This chart tells us very succinctly why the dollar is weak. There are far too many dollars accumulating overseas.

We hear a lot about "if it weren't for the oil imports, we'd be in good shape." Maybe so, but minus all the bunk, what this chart is telling us is that for whatever reason, the US is **living beyond its means**. It's telling us that consumption in the US is too high or that productivity in the US is too low—or both. The chart depicts a monetary hemorrhage, and just as a blood hemorrhage will kill a human being, a dollar hemorrhage will kill the US economy. The classical prescription for this kind of monetary hemorrhage is (a) higher interest rates and (b) an economic slump. The first tends to make the hemorrhaged nation's goods cheaper for foreigners to buy and therefore more attractive (at the same time, an economic slump reduces the standard of living for the hemorrhaging nation and therefore its urge to import foreign goods).

The US is now stubbornly resisting the classical remedy for a weak currency. Instead, the US is threatening to erect import

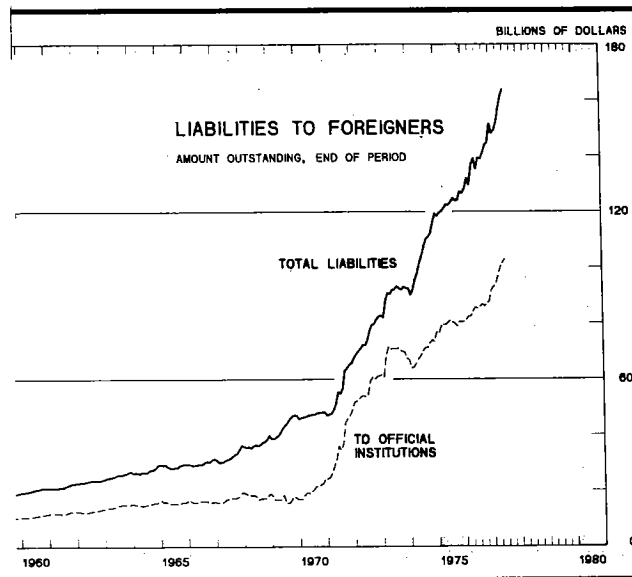


barriers. It is also pressuring Germany and particularly Japan to "re-plate" (in the hopes that a weak mark and yen will take pressure off the dollar). So instead of choosing the path of economic contraction and higher interest rates, the natural forces are being thwarted by a policy of easy credit and low interest rates.

The chart of household borrowing illustrates what I mean by "relaxed credit." On the installment credit and mortgage credit fronts, the rise since the 1974 recession low has been astounding. What is also clear is that it has taken a great deal *more credit* during 1974-77 to try to bail out the economy than it did during the 1958 recession or the 1960 recession or the 1970 recession. During 1974-77, credit virtually exploded, but despite this there is an underlying feeling that we're not experiencing real prosperity. What we are experiencing is a sort of "economic freak-out" generated by levels of borrowing never seen before.

What worries me is that at this point the US has simply **used up its capital**. Everything, and I mean everything, is awash in debt. The cities and municipalities, the citizens, the corporations, the banks, all of it is "loaned out." And this, of course, is the situation which has given rise to that hard-money creature disparagingly known as "the gold-bug." The goldbug's retort to all that I have shown here is this: "I don't care about timing, I don't care what month or even what year it goes. But the debt pyramid is now tottering, the dollar is melting away, and I don't trust anything in the inverted pyramid but the very tip—and that tip is the real money—gold. Sure I know that every factory is worth something, and every car is worth something, but **there's a loan against everything that exists in the US**. The only thing that will stand up when the loans are called is the real money, and that's gold."

As for me, I go over and over all the arguments, and I come up with a few frightening conclusions. Since World War II the nation's growth has been predicated on **cheap energy** and **cheap and easy credit**. The first is fast becoming a remembrance, and the second is coming into question. In the last Letter I went into the implications of the 6% discount rate, and I showed how a 6% discount rate in the past has always been an indication of economic sickness. A 6% discount rate has also always been associated with poor stock markets.



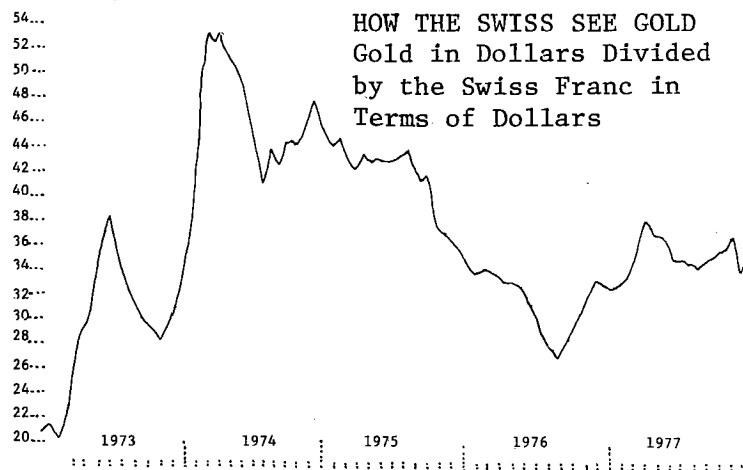
It is obvious to me and to most thinking people that in view of the weak dollar the US discount rate should be pushed higher. But because of Presidential pressure and because Washington doesn't think the economy could take it, the discount rate has been allowed to hold at 6%. Thus, the great dilemma faces the Fed today. If they raise the discount rate the market and the economy would probably slump. But if they do nothing, foreigners take this as a sign that we are "afraid" to defend the dollar (or worse, that our economy couldn't hold up under a dollar defense.).

So I'm wondering how long the nation can hold out against what I see as "the great unravelling"? I wonder how long confidence can hold up in the face of the debt expansion pictured on these charts. The easy answers are past, for NYC, for the stock market and for the nation. At any rate, I know I personally don't have any easy answers. And I guess what amazes me is the fantastic complacency that I see all around. Maybe the nation is just too numb to worry anymore. Maybe the consumer is saying, "The hell with saving, the hell with the old values, the dollar's going, and I can't save anyway, so I might just as well grab it and enjoy it now."

GOLD AND FRANCS: If you like mysteries, you'll love what's happening to gold and the Swiss franc. I include (p.6) a chart of gold as it looks to a Swissman who has been charting gold in Swiss francs. What we see here is the big 1973-74 bull market in gold, then the major 1974-76 bear market in gold. So far, so good.

In August, 1976, gold bottomed out, then it moved up nicely in terms of Swiss francs. But in March, as the franc advanced up steadily against the dollar, the price of gold in francs started sliding. A second gold rally took gold (in francs) to a second but lower peak. Since then the franc has literally exploded against the dollar, and the franc price for gold has fallen back to its January levels.

How can this be explained? I haven't heard a true explanation yet, but one thing is clear. Most of the world's gold is overseas. So far, hard money foreigners have preferred francs (and yen and marks) to gold. How long will this continue in the face of the weakening dollar? I don't know, nor does anyone else. But it seems to me that at some point the hard currencies will appear



very over-priced in terms of gold. At that point, investors and currency traders will move out of francs and marks and yen and into gold. It's an extraordinary picture, and I've never seen anything like it.

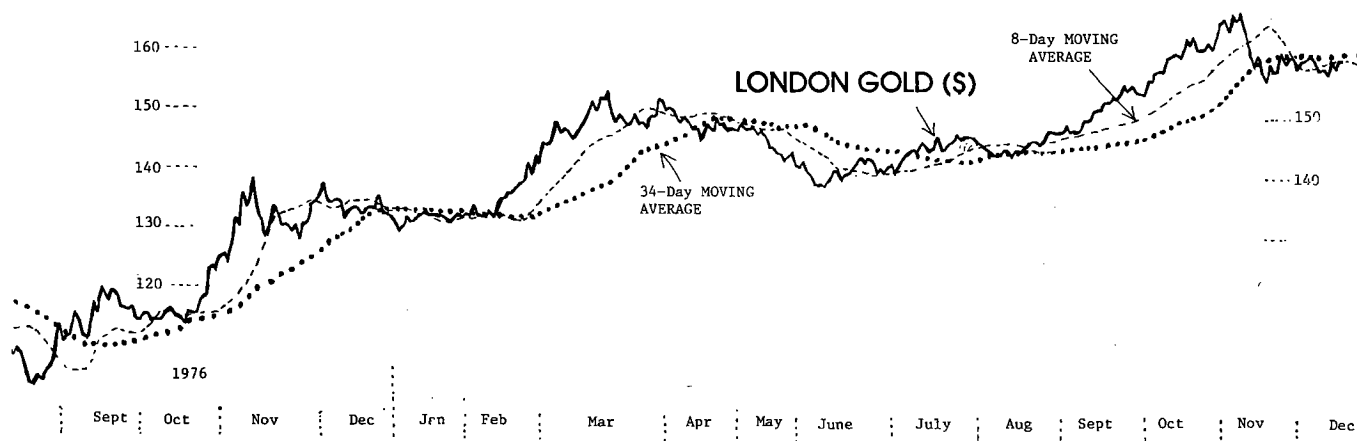
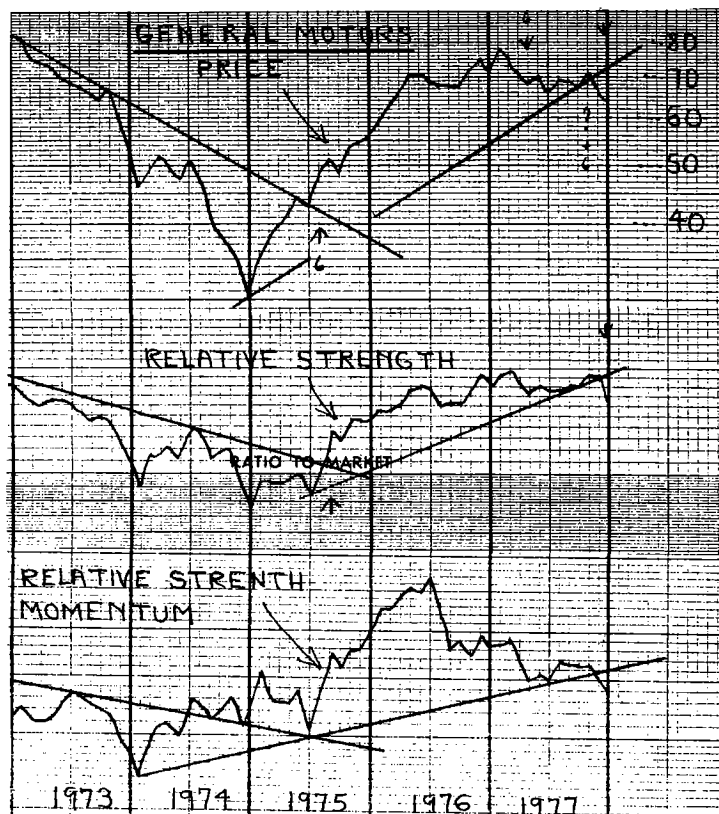
In a nutshell, what the chart is telling us is that since March of this year the real hedging against the sick dollar has taken the form of buying hard currencies—not gold. Personally, I believe the franc hedge is becoming overdone, and at this point I think gold looks cheap against the Swiss franc.

As an interesting aside, I note in today's newspaper that foreigners have purchased 80% or \$17.5 billion of the \$19 billion in new US bills, notes and bonds sold so far in 1977. Thus, the dollar weakness has to be costing foreigners a fortune in currency losses. The December 19 *Wall Street Journal* in a lead story discussed some of the grim implications and results of the falling dollar, not the least of which is that export nations (Japan, Germany) will be hit extremely hard as the cost of their goods (to US buyers) becomes prohibitively high. Germany's solution, says the article, is for the US to slash oil imports. But that would throw the US into recession. So the round-robin heats up with each nation accusing the other of neglecting its international duties. Prescription for 1978—a world struggle for trade.

At the bottom of this page I show a chart of the *daily* price movement of London gold (second fixing), and this is represented by the heavy black line. The lighter dashed line is the 8-day moving average (MA) and the dotted line is the 34-day

MA. This chart takes daily gold from its 103.50 low of August, 1976 to the present. Note that we are currently in the fourth correction since the 1976 low, and note the action of the 34-day MA on each correction. The 34-day MA has not turned down yet in the current correction, and gold is now hovering at around 160 with both MA's around that same price. If gold can touch 162, that should be a bullish signal, but sitting here around 160 for a while would not be bad action as far as my analysis is concerned. A price of 154 would mean that more corrective action lies ahead.

GM: This month there were two very important reversals in relative strength. They were the *Auto Group* to "down," and *General Motors* to down. I include on page 6 the monthly chart sent to me by Ray*Signals, 43 Lake Ave., Montrose, PA 18801. Here we see the major reversal in RS in General Motors which occurred in December, following a two-year rising trend. At the bottom of the chart is a year-to-year rate of change in RS or what I term "relative strength momentum." The chart is telling us that GM is now acting poorer than the market on an RS basis, and further that the RS in GM is declining at an accelerating rate (the latter we see in the RS momentum).



I consider this an ominous signal from the world's largest manufacturer, and it bears out my warning regarding GM in Letter 712. Sales statistics are starting to come through for GM, and they show a drop, and a drop specifically in the medium-priced cars. I expect the sales decline to continue into 1978. Obviously, this stock should be avoided, but the point is that falling auto sales will be a drag on the entire 1978 economy.

CONVERSATION: There's a conversation that's been going around and around in my brain, and I've been debating whether I should put it down on paper or not. I wrote this at 3:30 in the morning of December 17, and it's in front of me now. So I'm going to print it. Two ghostly figures out of my unconscious are talking; let's call one Mr. Fearman and the other Mr. Asker.

A. What's bothering you Fearman? You've been looking at the charts in Dow Theory Letters and wringing your hands. What's up?

F. I just don't like it. This whole debt situation is freaking me out. Listen, the entire world's beginning to slow down, economically speaking. The Germans, the Japanese, the French, the Italians, the Australians, you name it, they're slowing down. And business is getting tougher, more competitive. The competition is even hitting the Communist countries. The big struggle for world business and exports is happening—now.

A. All right, but this has all occurred before. What's it got to do with debt?

F. Everything; in the past the world could handle a slowdown. The dollar was strong, the US was the undisputed top world producer, and things would just slow down. Sure you had a few bankruptcies, but before long the Fed would start pumping. The US would inflate, and people would start feeling good and buying again. And then it was all over. But what worries me is that things are different now. At this point we've got a sick dollar, and there are maybe \$350 billion of them floating around Europe and the rest of the world. Foreign holdings of dollars are huge. Our sick dollar is beginning to really scare foreign dollar holders. Because of that, US interest rates are beginning to climb, particularly longer term interest rates. That scares me. For instance, look at this chart of S&P AAA-rate bond yields. Notice how they've been climbing ever since the '40's. And notice how the yields just climb, consolidate, then climb higher—no matter what. That's our debt talking, putting *never-ending pressure* on the money markets. It's ominous, very frightening.

A. Mmmm, I'll admit that it's not a pretty picture. But go on.

F. Well, aside from the whole bond spectrum creaking lower, I note that commodities are looking weak. Furthermore, in the face of the huge slide in the dollar, gold and silver have not really taken off. That bothers me. Is the weakness in commodities together with the sluggishness in gold and silver telling us that a big deflation is coming up?

A. Maybe it is. So what? Isn't everyone waiting for a little deflation or at least a drop in inflation?

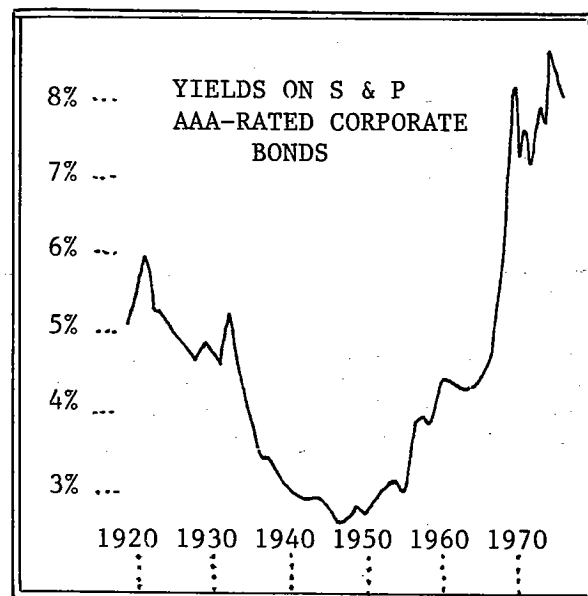
F. That's what they say, but they don't know the real alternative to inflation at this point in time. If we deflate here, we'll be smothered, absolutely crushed by our **debts**. It won't be a mild deflation, it will be a world collapse. Unlike the deflation of the 1930's, when the country had relatively *little debt*, this time a

deflation will make our debts unsustainable. If the nation deflates now, I'm afraid there'll be an unbelievable panic into cash, into dollars. And the reason will be that everyone will want to **raise money so they can stay afloat**. That kind of rush to cash will send interest rates through the roof and absolutely collapse the economy, which in turn will make the debts even more impossible to service. It will be a vicious circle of debt and interest rates choking the world.

A. You had to tell me this before Christmas? OK, assuming you're right, Fearman, assuming your doomsday scenario is correct, what do we do about it?

F. I'm not sure. But I would want to have my assets **outside the banking system**. And my best bet would be Treasury bills and gold, maybe 80% to 90% in T-bills, and the rest in gold, not gold stocks but gold coins and bullion.

A. But if everyone is rushing to raise money, maybe they'll sell their gold to raise dollars. You don't pay the bill collector with gold, you know, you pay him with dollars.



F. I know that, and then we have a problem of timing. The first reaction to deflation could be a rush out of everything, out of commodities, real estate, stocks, bonds, gold, silver, a headlong rush to sell everything to raise money as the economies collapse and as bankruptcies sweep the nation. But don't forget, dollars are basically a "US promise." A dollar is money because the US Government is still alive, and it says a dollar is legal tender. But in my scenario, the viability of the Government itself may come into question. Look, the Government is only as strong as its taxing and borrowing ability, and both of those could fall apart during a debt collapse. That's why gold is important. It's real money. It's what men have turned to for thousands of years when the panic's on. They've always accepted gold when they wouldn't accept anything else.

A. True, but if your debt cave-in hits, for a while it will be dollars that people will want. And gold could get hit hard—at least in the beginning.

F. I might buy that. For instance, if gold hits 155 on my chart it will be a bearish signal. At that time, maybe I'll want to sell some of my gold and then try to buy it back at lower prices. But

that kind of trading is very difficult, and I may not have the guts to buy gold back later. Frankly, I haven't decided what to do if gold heads below 155. I may hold all my gold or I may sell some, but then, I only have 15% of my assets in gold anyway. The rest is in T-bills.

A. How does gold fit into your total scenario then?

F. Well, somewhere along the line in this deflationary collapse, people are going to realize that the Government isn't going to just stand there. The Government will do what it does best. It will man the inflation pumps. The Government will start huge work programs, it will inflate in every way possible, the Fed will do everything it can to blow up the money supply. The Government, in short, will do the only thing it knows how to do. Print money and spend. That will represent the final destruction of the dollar. At that point, and I don't know how quickly 'that point' will come, (it could come very quickly), gold will sky-rocket. At that point gold will represent the only protection there is, and it will explode upwards as millions of citizens and corporations grab for it, and as gold hysteria reigns. And don't forget, Governments borrow against their gold. Gold is the base that you inflate with. The Central Banks will all want gold during a collapse, because gold is the core, the base of the money pyramid. No nation has corn or wheat or platinum or hog bellies listed in their reserves, they have gold and currencies.

A. But right now everyone is playing the Swiss franc game and the yen game and the German mark game. Why won't that continue?

F. Because those countries will be deflating, and their currencies may be sliding too. But more importantly, there will probably be exchange controls and all sorts of protectionist emergency laws. And you're not going to be able to buy Swiss francs and if you are able to, you'll be worried about being able to exchange them back into dollars. The currency thing will seem too far away and too risky. You'll want gold, because it's here, in your bank vault.

A. Well, I want to mull all this over. I still can't really take it all in.

F. It's a long shot, I'll be the first to admit it, because a catastrophe is always a very long shot, a once in a lifetime or two lifetimes occurrence. But this debt, we've never had anything like it in the history of the world. At this point we're all technically broke. All that's holding the whole thing up is the CONFIDENCE that you and I and New York City and General Foods and Gulf & Western and your landlord and your uncle will keep up the payments on their loans. When my father was alive, being solvent was having dollars in the bank and very few debts. Today, the dollar itself is in question, and being solvent is being able to pay the interest on your debt. There's no equity left, nobody has equity anymore, they just have asset-to-loan ratios.

A. Yes, but you're really talking timing. I mean this whole thing may or may not happen, but if it does happen it may not happen until 1999.

F. That's correct, but look, the *Bank Credit Analyst's* monetary thermometer has just turned bearish, the Dow Theory has signalled a bear market, my chart of the Industrial Average shows that there's nothing under the Dow if it breaks 790 until it gets down to the low 600's, and my breadth indicators are losing their

luster. I don't know if this is 'it' or not, but I know one thing. It's getting late. I know that no paper currency in history has ever survived. I know we have a bunch of incompetents in the White House. I know that the national debt is climbing at the rate of 100 billion a year now, I know that the cost of servicing the total US debt is eating the nation and its citizens alive. I also know that no one in Washington knows how, or wants to, get off this debt merry-go-round. And I know that the power of compounding debt will destroy any economic system ever invented. So my way of thinking is that I hope for the best and prepare for the worst.

A. Well, at least you got it off your mind, my friend. Do you have any good news for Christmas?

F. Yes, in my book we're here to learn. God promises us a learning experience, not a picnic. Picnics are for heaven. And I've got a feeling that some mighty big and interesting lessons are coming up. Remember, nothing is all black or all white. There are always alternatives, and there are opportunities in every disaster.

LATE MARKET NOTES: These last minute notes are hard to write, because the short-term and day to day movements are the least reliable and therefore the most difficult to judge. Most of the 1977 year-end tax selling should be out of the way by now, but despite this the market is very reluctant to rally. The December 6 low at **Dow 806** is important because it represents the low for December. Traditionally if the Dow breaks the December low anytime during January of the new year, it is a bad omen for the market for the rest of that year. Therefore, a lack of rally (or a poor rally) here in December, 1977, will set the market (and the Dow) up for an easy breaking of the December low during January.

Therefore, an ominous scenario, as I see it, would be a weak late-December rally which would take the Dow just a handful of points above the December low. This could be followed by an early breaking of the 806 December low. If the December low is broken in January, the Dow would then probably try to test its 1977 low of 800.85. Breaking that, the Dow would probably test the 796.19 halfway (50%) level of the bull market. If 796.19 is decisively violated, we would be, to put it mildly, in big trouble.

As this is written, the bond market is "on the edge of the cliff" with bonds of all kinds (particularly the long-term, of course) ready to head down. The weakening dollar is beginning to take its toll, and another increase in the discount rate "should" arrive at any time. Another discount rate increase, while it might temporarily help the dollar, would be very bearish for the stock market. Watch the Utility Average. A close at 108 would represent a major sell signal, but I have already advised selling Utility stocks. I hereby repeat that advice.

I've made this an 8-page Letter, which is a lot to ask you to read. But I'm also going to take two weeks between this Letter and the next (which will go out on January 5), so you will have plenty of time to wade through these 8 pages.

My very best to all my subscribers, to all my fellow analysts, and all my friends who read this. Happy Holidays and remember, we'll all get "what we need."

NEXT MAILING: January 5th